RIGHTS OF TRUSTEE IN BANKRUPTCY IN LIFE INSURANCE POLICIES.

IN THE administration of many bankrupt estates, questions arise as to the respective rights of the trustee, bankrupt and beneficiaries in policies of insurance on the life of the bankrupt and they have given rise to many decisions in the various Federal Courts that have not been altogether harmonious.

In a series of decisions by the Supreme Court many of these questions have by now been definitely decided by the ultimate authority, and it is the purpose of this article to briefly summarize what seems to be the correct interpretation of the Bankruptcy Act in the light of these decisions.

The sections of the Act bearing on these questions, so far as material, are as follows:

§ 6. "This Act shall not affect the allowance to bankrupts of the exemptions which are prescribed by the State laws in force at the time of the filing of the petition. * * *"

§ 70a. "The trustee of the estate of a bankrupt * * * shall be vested by operation of law with the title of the bankrupt as of the date he was adjudged a bankrupt, except in so far as it is to property which is exempt to all. * * *"

"(5) property which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him: Provided, that when any bankrupt shall have any insurance policy which has a cash surrender value payable to himself, his estate, or personal representatives, he may, within thirty days after the cash surrender value has been ascertained and stated to the trustee by the company issuing the same, pay or secure to the trustee the sum so ascertained and stated, and continue to hold, own, and carry such policy free from the claims of the creditors participating in the distribution of his estate under the bankruptcy proceedings, otherwise the policy shall pass to the trustee as assets."

The evident purpose of § 6 is to preserve to the bankrupt all exemptions granted by the State laws, and it would seem necessarily to follow that if an insurance policy were exempt by the State law it would be exempt in bankruptcy. On this point, though, the lower Federal Courts seem to have been divided, some holding that the proviso attached to § 70 relative to insurance should be considered as superseding all effect that § 6 might have, and that the State exemption laws as to insurance would not apply in bankruptcy.[1] Other courts held that § 6 prevented any policy exempt by the State law from becoming subject to the proviso in § 70, and it was only non-exempt policies under the State law that could ever pass to the trustee in bankruptcy.[2]

In Holden *v.* Stratton[3] the Supreme Court held that the latter view was correct, and any State statute exempting insurance policies was to be given full effect in bankruptcy by virtue of § 6. We are thus concerned in bankruptcy only with policies that are non-exempt under the State law.

Assuming, then, that there is no State exemption statute, and that § 70a becomes operative, exactly what is the effect of that section?

In the first place, it is evident that if the proviso attached to this section had been omitted, the broad language used would have been sufficient to pass to the trustee any interest of the bankrupt in a policy on his life, subject of course to any vested rights of the beneficiary. The addition of the proviso raises this important question, viz: Do all policies pass to the trustee in the first instance by virtue of the broad language of § 70a, subject to redemption by the insured by paying the cash value according to the proviso attached to that section, or, is this proviso the entire law on the subject, and no policy passes to the trustee in the first instance, but only upon failure of the bankrupt to pay the cash value within thirty days, and no policies can be affected in any event by bankruptcy unless they conform to the description found in the proviso as "policies having a

[1] In re Scheld (C. C. A.), 104 Fed. 870.
[2] Steel *v.* Buel (C. C. A.), 104 Fed. 968.
[3] 198 U. S. 202.

cash surrender value payable to himself, his estate or personal representative"?

In other words, does this proviso merely grant the bankrupt the privilege of redeeming certain policies that have already passed to the trustee, or does it define and limit *all* policies that *can* pass to the trustee in any event?

The solution of this question is evidently of importance to the trustee, for under the first view the proviso is merely a limitation on his power, while in the second it is the limit and source of all his power, as to insurance policies on the life of the bankrupt.

The usual purpose of a proviso is merely to limit the operation of the preceding language of the law, and it would seem but natural that the proviso attached to § 70a should be so construed, and held to be simply a benefit conferred on the bankrupt as to certain described policies that have already passed to the trustee by virtue of the preceding general language of the section. It was so held by many of the lower Federal Courts, and in fact assumed as undisputed in others prior to the decision of Burlingham *v.* Crouse.[4]

The decisions of the Supreme Court in Hiscock *v.* Mertens[5] and in Burlingham *v.* Crouse[6] show the importance of a correct solution of this question, and the latter decision seems to settle it definitely.

In Hiscock *v.* Mertens[7] the bankrupt had a tontine policy payable to his estate which at the time of adjudication had no stipulated cash surrender value, but for which the company would pay some $5,800 if surrendered as of that date. However, by the express terms of the policy it would have a cash surrender value of about $11,000 upon the completion of the tontine period, some six months after the date of the adjudication. Hence the trustee was very anxious to secure the policy to the estate and keep it in force to the expiration of the tontine period and collect the full $11,000. The bankrupt offered to pay $5,800

[4] 228 U. S. 459. See In re Slingluff, 106 Fed. 154; In re Hettling (C. C. A.), 175 Fed. 65; In re O'Hear (C. C. A.), 178 Fed. 632, 228 U. S. 459.

[5] 205 U. S. 202.

[6] *Supra.*

[7] *Supra.*

to redeem the policy, this being the amount the company would pay for its surrender. This the trustee refused on the theory that as the policy did not by its terms provide for any cash surrender value as of the date of the adjudication, or any other date prior to the expiration of the tontine period, it did not fall within the terms of the proviso of § 70a, and hence there was no right in the bankrupt to redeem. This argument is evidently based on the theory that the policy had already passed to the trustee independently of the proviso and as it did not meet the description of policies referred to therein it could not be redeemed.

This question was not decided as it was held that the policy did come within the class mentioned in the proviso as having "a cash surrender value," even though it was granted only by a *custom* of the company. Hence the argument for the trustee broke down on this point, and the soundness of his premise—that the policy had already passed to him subject to redemption—was not considered.

Under the later decision of Burlingham *v.* Crouse,[8] this premise would appear unsound, and this decision requires an exact reversal of the arguments advanced on behalf of the trustee and bankrupt respectively in cases similar to Hiscock *v.* Mertens,[9] for it was there in effect decided that the entire measure of the rights of the trustee is found in the cash value attaching to policies payable to the bankrupt or his estate—in other words, that the proviso is exclusive legislation on the subject.

In Burlingham *v.* Crouse,[10] the question arose on the following facts:

T. A. McIntyre was insured in the Equitable Life Insurance Company for $100,000, the policies being payable to his estate. In April, 1907, these policies were assigned by McIntyre to his firm of McIntyre & Co. and shortly thereafter the firm borrowed from the Equitable Company the full surrender value of the policies, some $15,000. In February, 1908, these policies were assigned by McIntyre & Co. to one Crouse and some two months

[8] *Supra.*
[9] *Supra.*
[10] *Supra.*

later McIntyre & Co. and the individual members of that firm were adjudged bankrupts.

McIntyre died shortly after he had been adjudged a bankrupt and the trustee of T. A. McIntyre & Co. filed suit against Crouse to set aside the transfer of the policies to him as a preference made within four months before bankruptcy intervened. The trustee claimed the entire proceeds of the policies and the question arose as to whether such an action could not be maintained. As the transfer to Crouse had been made within four months of the bankruptcy and was thus admitted to be subject to attack, the question resolved itself into whether the trustee would have been vested with the title to the policies in the absence of the transfer to Crouse. If so, he could maintain the action to set aside the preferential transfer of the policies as of any other property coming into his hands.

It was held by the Supreme Court that only those policies vest in the trustee that have a cash surrender value available which the bankrupt fails to pay, and as the entire cash value of McIntyre's policies had been covered by the loan made by the company, the policy could not pass to his trustee. This being so, it followed that the trustee could maintain no action to recover the proceeds of the policy from Crouse. The court bases this conclusion on the theory that the proviso attached to § 70a contains the whole law relating to insurance policies as affected by bankruptcy, and that under its provisions only the cash surrender value passes to the trustee. While admitting that the general language of § 70a (5), relating to property passing to the trustee, is broad enough to cover insurance policies and that policies would pass in the absence of the proviso attached to that section, yet the Court holds that this proviso goes further than to qualify the general language, and in fact supersedes it as far as insurance policies are concerned. The court said:

> "True it is that life insurance policies are a species of property and might be held to pass under the general terms of subdiv. 5, § 70a, but a proviso dealing with a class of this property was inserted and must be given its due weight in construing the statute. It is also true that a proviso may sometimes mean simply additional legislation, and not be intended to have the usual and primary office of a proviso,

> which is to limit generalities and exclude from the scope of the statute that which would otherwise be within its terms."

Construing the proviso as "additional legislation" the court holds that it was "the purpose of Congress to pass to the trustee that sum which was available to the bankrupt at the time of bankruptcy as a cash asset; otherwise, to leave the insured the benefit of his insurance."

It is evident, then, that in the first instance no right passes to the trustee in bankruptcy by virtue of the adjudication as to any policy of insurance, and it is only upon the bankrupt's failure to pay or secure the cash surrender value of any policy payable to his estate to the trustee within thirty days from the ascertainment of such value that the trustee acquires any right to the policy. If there is no cash surrender value, there is nothing to pay to the trustee and there is no need of the bankrupt making a vain offering to pay nothing. Hence, such a policy stands on the same plane as one, the cash surrender value of which the bankrupt has paid within the thirty days.

It has been generally considered that the bankrupt has thirty days within which to "redeem" the policy, and the matter is thus usually mentioned in bankruptcy proceedings. Such, however, is not the case. The bankrupt has never been divested of title to the policy by the bankruptcy prior to the expiration of the thirty days and the trustee has no right to the control or custody of the policy, until the bankrupt fails to pay its surrender value within the prescribed period. Then for the first time it passes to the trustee. True, the cash value passes at once to the trustee, and the policy may be considered as security for it. On this theory it was held in Burlingham *v.* Crouse [11] that, when the bankrupt had borrowed from the company the full cash value of his policy, nothing passed to the trustee in bankruptcy.

In Everett *v.* Judson.[12] an involuntary petition in bankruptcy was filed against the insured on December 17, 1910, and on January 4, 1911, he committed suicide. Adjudication in bank-

[11] *Supra.*

[12] 228 U. S. 474.

ruptcy did not occur until January 9, 1911, and the question arose as to whether the trustee's rights in the policy vested at the date of the filing of the petition or at the date of adjudication. If at the latter date the entire proceeds of the policy were payable to the trustee, as Judson was dead by then. The date of filing the petition was held to "fix the line of cleavage with reference to the bankrupt's estate," and Judson being then alive, only the cash value of the policy as of that date passed to his trustee in bankruptcy, the rest of the proceeds of the policy passing to his executor.

Andrews *v.* Partridge [13] involved simply the question whether the privilege of paying the cash surrender value was personal to the bankrupt or could be exercised by his executor, he having died shortly after the adjudication.

As under Burlingham *v.* Crouse,[14] only the cash surrender value vests in the trustee, it would naturally follow that the bankrupt's executor could pay that to the trustee and collect the policy from the company, and it was so ruled.

Following the ruling in Burlingham *v.* Crouse [15] it may be considered as determined that the proviso to § 70a is not a true proviso but in reality "additional legislation" and as such contains the entire law as to the rights of the trustee in policies of insurance. This being true the result may be thus summarized:

1. The rights of the trustee are fixed as of the date of the filing of the petition.

2. Only those policies pass to the trustee that are payable to the bankrupt or his estate, and have a cash value at the date of the filing of the petition which the bankrupt fails to pay or secure to the trustee after thirty days of receipt of due notice to do so.

Thus no policy passes in the first instance to the trustee but only upon failure of the bankrupt to pay the cash value. It is the latter right that passes and not the policy itself.

A literal reading of the proviso prevents any policy from passing, even though it has a cash value, unless it is payable to "him-

[13] 228 U. S. 479.
[14] *Supra.*
[15] *Supra.*

self, his estate or personal representatives." This latter phrase evidently refers to the *policy* and not the *cash value,* for it involves a contradiction of the insurance policy itself for any cash value to be payable to the *estate* of the insured, for upon his death the face of the policy becomes payable. (44 Insurance Law Journal 116.) The cash value is available only during the life of the insured.

The effect of Burlingham *v.* Crouse [16] and its companion cases was considered in In re Churchill [17] by the Circuit Court of Appeals for the Seventh Circuit. There the bankrupt held a paid up tontine policy with his wife as beneficiary. Adjudication occurred September 15, 1910, and the tontine period would end on December 8, 1912, at which latter date the insured would be entitled to certain valuable options, among others to cash out the policy. It was ruled by the lower court that as there was no surrender value available when bankruptcy intervened, the bankrupt had no right of redemption under the proviso in § 70a. This was the same claim made in Hiscock *v.* Mertens,[18] and not passed upon, as it was found that there was a cash value given by the custom of the company, as mentioned above.

The ruling of the lower court found support in many cases, particularly in In re Welling [19] but when it came on for review in the Circuit Court of Appeals, Burlingham *v.* Crouse had been decided and it was ruled on the authority of that case that the trustee in bankruptcy took no rights under the policy.

In re Draper [20] involved practically the same facts as In re Churchill, and the decision by the District Court of New York was similar to that of the lower court in In re Churchill, and held that the policy passed to the trustee. No reference is made in the opinion to Burlingham *v.* Crouse or In re Churchill although decided after both of these cases, and as the opinion squarely conflicts with them it must be considered as erroneous.

The opinion is not convincing and is based on In re Hettling.[21] It is true that in both the Draper and Hettling cases the policy gave the insured the right to change the beneficiary, but that

[16] *Supra.*
[17] (C. C. A.), 209 Fed. 766.
[18] *Supra.*
[19] (C. C. A.), 113 Fed. 189.
[20] 211 Fed. 230.
[21] 175 Fed. 65.

element was only mentioned to place the policy on the same plane as if payable to the bankrupt, and the real ground of decision was that there was no cash value available to the bankrupt, and hence he could not "redeem" it under § 70a. The Hettling case was in effect overruled by Burlingham *v.* Crouse, a fact that was overlooked in the Draper case.

In Burlingham *v.* Crouse the court says:

> "We think it was the purpose of Congress to pass to the trustee that sum which was available to the bankrupt at the time of bankruptcy as a cash asset; otherwise to leave to the insured the benefit of his life insurance."

As a general rule the cash value of a policy is available to the *insured alone,* only in policies payable to his estate, and in fact the language of the proviso in § 70a limits its operation to cases where the bankrupt has a "policy which has a cash surrender value payable to himself, his estate or personal representatives."

If the policy is payable to a designated beneficiary it does not meet this description, and moreover it is a well-known custom of insurance companies to pay no cash value except upon request of the insured and all beneficiaries.

Hence no such cash value can be said to be "available" to the bankrupt, for evidently to be such it must be within the power of the bankrupt by himself to obtain the cash value.

Suppose, however, as is very common that the policy is payable to a designated beneficiary, but with a right reserved in the bankrupt to change the beneficiary. Does this make the cash value available to him? Evidently prior to bankruptcy he could have changed the beneficiary to his estate, and so made its cash value available to him alone. If the proviso in § 70a is "additional legislation" as said in Burlingham *v.* Crouse, and the trustee must look alone to its terms for his interest in any policy, it would seem necessarily to follow that no policy payable to the bankrupt's wife even with the power reserved to change the beneficiary is affected, for such policy does not meet the description found in the provision in that it is not payable to the estate of the bankrupt.

But does the power to change the beneficiary reserved in the policy pass to the trustee so as to enable the policy to be changed so as to meet the description found in the proviso? If so, it must be by virtue of § 70a (5), which provides that the trustee shall be invested with "power which he (the bankrupt) might have exercised for his own benefit but not those which he might have exercised for some other person." It was held in In re Orear [22] that such a power did pass, but it may be noticed that the court adopted a construction of § 70a that was later held erroneous in Burlingham *v.* Crouse, by saying that § 70a is merely a limitation on the trustee's power, instead of being the source as held in the Burlingham case. Moreover, the dissenting opinion of Judge Pollock in the Orear case presents very strong arguments that such a power is not one that would pass to the trustee. He points out that in the very nature of things the power reserved to change the beneficiary could not be made for the benefit of the insured, for he would be dead when the policy becomes payable, and hence the power does not fall under § 70a (5).

In this same case on a second appeal (In re Orear) [23] it was held that the reservation of the right to change the beneficiary did not exclude the policy from the benefit of the exemption statute of Missouri under which policies payable to the wife of the insured are exempt from the claims of his creditors. The court, after stating that practically all modern policies contain the right to change the beneficiary, said:

> "The primary purpose of such policies is still to insure against death and usually for the benefit of those dependent upon the insured, and when a modern policy is made, as in this case, payable upon the death of the insured to his wife by name as beneficiary, the fact that the insured may have the right to change the beneficiary or enjoy certain collateral rights in his lifetime does not make it any the less a policy of insurance made by an insurance company expressed to be for the benefit of the wife of the insured within the meaning of the statute in question, and to hold otherwise would be to hold that the Legislature of Missouri enacted a statute with reference to a kind of policy no longer used."

---

[22] 178 Fed. 632.

[23] 189 Fed. 888.

In re Pfoffinger [24] is to the same effect under the Kentucky statute. There are other cases that take the contrary view, but they were all decided prior to Burlingham *v.* Crouse, and it is believed that the decision in that case changes the entire viewpoint from which the question has heretofore been considered. As this decision restricts the rights of the trustee to whatever cash value is available to the bankrupt at the time of the filing of the petition, it seems clear that if on the date of filing the petition the reserved right to change the beneficiary has not been exercised, the cash value does not pass to the trustee.

It may therefore be considered as finally determined that the rights of the trustee are fixed as of the date of the filing of the petition (Everett *v.* Judson) and that there then passes to the trustee as his sole right in any policies on the bankrupt's life, the cash surrender value available to the bankrupt as of that date, but if no cash value is available, whether from the terms of the policy or its previous use by way of a loan nothing passes to the trustee (Burlingham *v.* Crouse). If the bankrupt does not pay the cash surrender value to the trustee within thirty days after its ascertainment the policy passes to the trustee, but this payment may be made by the executors of the bankrupt (Andrew *v.* Partridge).

Rodman Grubbs.

LOUISVILLE, KY.

---

[24] 164 Fed. 526.